



DEPARTMENT OF STATE

Washington, D.C. 20520

82-4253/3

SECRET

February 10, 1982

Senior Interdepartmental Group No. 15

To:	OVP	- Mrs. Nancy Bearg Dyke
	NSC	- Mr. Michael O. Wheeler
	DOD	- COL John Stanford
	JCS	- LTC Edward Bucknell
	Commerce	- Ms. Jean Jones
	USTR	- Mr. Richard Heimlich
	Treasury	- Mr. David Pickford
	CIA	- [Redacted]

FEB 10 4 43 PM '82

25X1

Subject: SIG Meeting on Poland

Attached are two papers prepared by Treasury for use at today's SIG meeting on Poland.

L. Paul Bremer, III
 L. Paul Bremer, III
 Executive Secretary

Attachments:

As stated.

NSC review completed - may be declassified in full

State Dept. review completed

SECRET
 GDS 2/10/88

SECRET

Treasury Paper #1) JK

Financial Pressure on the Soviet Union

The foreign financial position of the Soviet Union worsened considerably during 1981. From a period of increasing their reserves from the second half of the 1970's until 1980, the Soviets are now faced with poor grain harvests, high cost capital imports linked to energy development, and soft markets in the West for their exports.

As a result of these difficulties, the Soviets in the first nine months of 1981 reacted by drawing down cash reserves, i.e., reducing their precious hard currency deposits on Western banks, by almost 50% from \$8.6 billion to \$4.5 billion (as of September 1981) and by increasing their hard currency borrowing -- primarily in short maturities -- by \$2 billion. (In other words, the USSR's external position worsened by \$6.1 billion in the first nine months of the year.)

In addition, they have been forced to sell 60 percent, or 6 million ounces, of their 1981 domestic gold production to raise another \$2.8 billion; in 1980, about 30 percent of their gold production was sold. As we expect the Soviets' economic position to deteriorate further this year, they will have to sell all of their gold production and dip into their stocks for an additional 2-5 million ounces to meet their hard currency needs.

International financial markets are aware of the Soviet cash flow problems, which have been widely publicized. U.S. bankers, including overseas branches and subsidiaries, have steadily reduced their lending and exposure to the USSR and have shortened maturities as well; from the end of 1980 through September of 1981, U.S. bank exposure (loans and commitments) fell by \$525 million, leaving only about \$600 million outstanding.

In addition, there are publicized reports from Japan and Europe that the Soviets are increasingly squeezed for hard currency and seeking delays in payments and a lengthening of traditional trade financing terms (normally 30-60 days). These requests have been refused by Western bankers. Western European (as well as U.S.) banks have been consistently shortening maturities; in mid-1980, 32 percent of Soviet debt to Western bankers was in the one-year and under range; by mid-1981, the percentage of that short-term range had increased to 47 percent. As this short term debt matures, the Soviets will be under increasing pressure for cash to repay or new funds for refinancing.

SECRET

The weakened Soviet financial position in itself has helped to bring about a virtual standstill of long-term credit to the Soviets, and should also raise the cost of short-term funds. At the present time, there are no private, unguaranteed long term credits going to the Soviet Union. Private bankers expect the hard-currency squeeze to continue for several years.

The U.S. Government can help exacerbate Soviet difficulties. We plan to raise the weakened Soviet financial position at meetings of the Bern Union, which bring together official and private export financing agencies. In official statements, we are calling attention to the deterioration of the Soviet Union's financial position as well as the heightened burdens resulting from Polish and other Eastern European debt. Such statements will in themselves give a message to the international banking community, which is already well aware of the risks. We can also seek cooperation from our Allies on cutting back on luxury import goods from the Soviet Union such as furs, diamonds and other non-essentials. This course of action should be explored by our mission to Europe in the coming weeks.

One important area of Soviet access to Western credit in which we feel that significant measures can be taken to squeeze the USSR is the field of official export credits and credit guarantees, on which the Soviets are counting for as much as \$1.7 billion to meet their financing requirements this year. There is considerable, although by no means unanimous, international support for increasing the interest rate which the Soviets must pay on such credits. Even though most of our NATO partners, have in mind only a small and largely symbolic increase, this step would nevertheless require a very high level political undertaking by European governments. Furthermore, any new rates would apply only to new commitments and not to the \$1.7 billion in outstanding commitments which the Soviets can draw down in the next year or so. Nevertheless, an increase in the interest rate can cause some pain to the Soviets and will have political and symbolic value.

More important, we believe that it may be possible to negotiate with the NATO allies and Japan for an agreed limitation or rationing of the volume of export credits and credit guarantees which they provide to the USSR and Eastern Europe. An embargo on such credits cannot be realistically expected, because the Western Europeans have shown no willingness to give up sales to the East. Realistically we can ask them to hold credit and guarantee draw-downs during 1982 and 1983 to levels at some point below those of credits guaranteed last year. Such an agreement could be attractive to the Europeans as involving only marginal cutbacks in business and employment for their exporters to the East,

SECRET

- 3 -

and it could be handled independently of the difficult and contentious issues of credits for the Yamal Pipeline. Moreover, quantitative restrictions of this type are far more amenable to transparent equitable burdensharing than are interest rates which are subject to widely variant levels of subsidization among exporting countries. This issue might well be raised by our mission to Europe in the next few weeks.

Gold Sales

Since the Soviets will have to rely heavily on gold sales as a source of foreign exchange -- our estimate is \$4.5 billion for 1982 -- it has been suggested that we try to force down the price of gold through sales of our own. While this may be appealing to some, our considered view is that it is highly dubious that such a program will accomplish its objectives and carries substantial cost to the United States.

The world gold market is currently soft. It is not highly speculative or volatile. Inflation, a primary motive for purchasing gold, is declining, and interest rates are high -- resulting in a very high carrying cost for gold. Stepped up Soviet sales have over the past six months contributed to the decline in gold prices, from \$450 per ounce in September to around \$380 currently. However, a continuation of Soviet sales at the recent pace would not of itself be expected to drive the price down substantially further. The market generally expects Soviet sales to continue. There is no expectation at this time of a U.S. gold sales program, though the market is aware that the possibility of U.S. sales always exists.

An announcement of a U.S. sales program -- especially a program quite openly aimed at affecting the price -- could be expected to reduce gold prices immediately and substantially. (This contrasts with price developments during the 1978 - 79 U.S. gold sales program, when prices rose. Market conditions are substantially weaker today, however, and at least an initial price effect seems likely.)

Whether gold would continue to trade at lower levels, would depend in part on:

- actual U.S. gold sales;
- the possibility of stepped up gold demand by OPEC and other purchasers attracted by the lower price or larger assured availability;

SECRET

- the reaction of the Soviets, i.e., whether they stepped up their own gold sales or withdrew to see how the market developed; and
- the reactions within the U.S. and in other major countries.

A drop of, say, \$50 in the gold price, if sustained, would require the Soviets to sell 13.6 million ounces to obtain the \$4.5 billion in receipts assumed above for 1982. The additional sales required by a price reduction of this size -- 1.8 million ounces -- would amount to only three percent of their gold reserve.

To be of significant or lasting effect on the Soviets, very substantial and sustained U.S. sales might be required, entailing both a reduction of the U.S. gold stock (264 million ounces) and a reduction of the market value of the remaining U.S. gold. The market would need to accept the credibility and sustainability of the U.S. sales program.

In embarking on a major sales program, the U.S. should be aware of the impact on U.S. and other producers (e.g., South Africa and Canada), and of the impact on the value of other countries monetary reserves. If significant sales were necessary, criticism could be expected to mount from Congressional and other sources opposed to reduction of U.S. gold holdings or sales at "bargain prices."

If the Soviets chose to, and were able to, withdraw from the gold market for a time, the problems for the U.S. to sustain gold sales or the threat of gold sales would increase. The U.S. would need to be prepared, therefore, for a period of time during which its sales program -- while effective in reducing gold prices -- might not be perceived to have much impact on the Soviets. While they are in a hard currency bind and may be hard pressed to acquire the credit they need for minimal growth, the Soviets could probably stay out of the gold market for a few months.

While a U.S. gold sales program could pose increasing costs to the Soviets over time, they could pull out of the market while we were depleting our own stocks. In view of the major uncertainties about the success of a program designed to reduce the gold price over an extended period; the possible wide-ranging domestic and international effects; and the limited, near-term costs to the Soviets of a lower gold price, it is recommended that the United States not implement gold sales for this purpose at this time. We should retain this option for consideration if the Soviet position becomes tighter and their need to maintain gold sales greater.

SECRET

- 5 -

Conclusion

There are four areas in which an increased financial squeeze on the Soviets can be considered: (1) limits or embargoes on Western imports from the USSR, which would deny foreign exchange earnings to the Soviets; (2) limits on Western exports -- and associated export credits -- to deny resources to them; (3) reductions in Soviet access to private Western credit markets; and (4) U.S. gold sales aimed at depressing the price at which the Soviets would have to sell their gold in order to obtain hard currencies.

Western Imports

There probably is some scope for a joint Western embargo on imports of luxury goods and other non-essentials from the USSR and the Eastern Bloc. The U.S. mission should pursue this objective.

Export Limitations

Soviet imports of capital goods and other industrial products from the West normally are financed by official export credits or credit guarantees. It may be possible to negotiate with the Allies some limited and reasonable quantitative cap on Soviet access to such credits for the next year or two, aside from any agreed positions that may be taken on exports to support the pipeline.

Soviet Access to Private Credit

To a considerable extent, the market is already taking care of this. No new unguaranteed long-term private credits are flowing to the East; Western bankers are doing everything they can to shorten maturities and reduce exposure; and the only credit that is flowing is short-term trade-related lending. There is a role for the Government in seeing that the private sector understands the riskiness of lending to the East and the increasing lack of creditworthiness of the Eastern countries.

Gold Sales

U.S. gold sales designed to spoil the market into which the Soviets would have to sell would be most effective in a situation where disposal of its gold holdings had become the USSR's last financial resort. Such a situation does not yet exist. Therefore, our best course is to hold off on this option, for review at a later time.

SECRET

SECRET*Treasury Paper # 2*The Soviet Union's Hard Currency Situation

At the February 4 NSC meeting, a question arose as to what the Soviet Union's hard currency balance of payments prospects are. An analysis of the situation is outlined below:

The Soviet Union experienced a sharp erosion in its hard currency position during the past year. This weakening is due primarily to a combination of increased imports from the West -- especially grain -- and soft Western markets for Soviet crude oil and other primary product exports. The current situation represents a turnaround from the strong position the USSR enjoyed during the past several years, when increased revenues from energy and raw material exports to the West allowed a substantial buildup of hard currency reserves as well as a steady growth of imports from the West.

This is not to say, however, that the USSR is on the brink of disaster. Its capacity to service its debt remains good; it has substantial amounts of hard currency assets. Its gold stocks are worth \$20-25 billion at current market prices, and its deposits in Western banks total some \$5 billion (as of September 1981). Nevertheless, the Soviets will not be able to continue to import substantially more from the West unless they can borrow massive amounts. Even to maintain their current import levels, they would need to increase their borrowing significantly. Their alternatives will be to cut their imports sharply, and/or sell substantial amounts of their gold.

In 1981, the Soviet Union was able to finance its \$6 billion trade deficit in a variety of ways. It drew down its hard currency assets in Western banks by some \$4 billion through the first nine months; sold gold for \$2.8 billion (almost \$1 billion more than in 1980), and increased its borrowing -- primarily in the form of short-term trade credits. The USSR also benefited from increased arms sales -- up \$1.7 billion on the strength of orders from previous years.

As for this year, the USSR's hard currency situation is continuing to deteriorate, and its trade deficit is projected

Classified by MELeLand
Review for Declassification
2/9/2002

SECRET

SECRET

-2-

at \$8 billion compared to \$6 billion last year.^{1/} It will be hard-pressed to come up with the resources to meet this increased deficit because it faces continued soft demand for its exports in world markets -- especially in Western Europe. (The critical factor will be whether oil prices continue to decline.) On the import side, we expect the Soviet Union's agricultural import bill to increase by about \$1 billion. According to numerous reports the USSR is cutting imports in other areas, in part just to offset the effects of expected Western price increases. Taking these factors into account, the Soviets' hard currency trade balance could deteriorate by as much as \$2 billion in 1982 to the above \$8 billion figure.

Moscow has some options available to meet its prospective financing requirements. They involve, however, a continuing financial squeeze or a depletion of a national asset, gold. Moscow has commitments for about \$1.7 billion in guaranteed credits to be used primarily to purchase machinery and other goods not associated with the pipeline. The Soviets would have the option of drawing upon hard currency deposits in Western banks, which totaled about \$4.5 billion as of September 1981 (compared to \$8 billion in December 1980). Finally, they will have to sell large amounts of gold. Estimates range between 12 and 15 million ounces, an amount which exceeds the USSR's annual 10 million ounce production and would be more than double their sales of 1981.

The Soviets will not be able to turn to their East Bloc allies for assistance. The Eastern European countries have been experiencing financial difficulties, and their prospects are not likely to improve, with adverse consequences for their balance of payments positions. Some are finding it difficult to manage their internal and external economic sectors and are encountering problems with servicing their debt and finding new financing. In fact, the Soviets face the prospect of having their Bloc allies turn to them for assistance, at a time when the USSR can ill afford it. Almost certainly, the USSR

1/ These figures and the subsequent discussion on financing do not include the import and the government guaranteed financing arrangements for the Siberian pipeline. Most of the imports for the pipeline would be covered by Western credits. Consequently, it would be of little significance for Soviet financing needs over the next few years.

SECRET

SECRET

-3-

will not be willing to provide such assistance in hard currencies, although it may be forced to transfer real resources by exporting more goods to its allies than it imports.

Many of the factors that have contributed to the weakening of the Soviets' hard currency position will continue to keep Moscow in a hard currency bind for the foreseeable future. Only an unlikely combination of events -- a tightening of Western oil markets, a series of good Soviet grain harvests and a strong pick-up in Western economies -- would offer relief.

The only large new source of hard currency earnings on the horizon -- and it is far away -- is the Siberian pipeline, which should yield about \$5 billion a year in net hard currency earnings by the late 1980's, but will involve a net drain of foreign exchange in the next few years. This increase could be offset to some extent, however, by a decline in earnings from oil exports. Most experts agree that Soviet oil production has leveled off and a decline is in prospect for the 1980's, but there are differences of opinion as to what its magnitude will be.

The prospects for stagnation or decline in Soviet foreign hard currency earnings during the 1980's indicate that Moscow will be unable to increase the volume of its hard currency imports unless the West provides more credit and Moscow accepts a larger hard currency debt. Rather than build up a large debt, however, the Soviets probably will slowly cut back on imports of the least essential products. Further cuts would necessitate difficult decisions in the longer term because the bulk of their hard currency imports are important to high priority Soviet goals for food production, energy development, and raising the level of technology and productivity of Soviet industry.

Attachment:

Table: Sources and Uses of Hard Currency

Classified by MELeLand
Review for Declassification
2/9/2002

SECRET

Sources and Uses of the Soviet Union's Hard Currency: 1981; 1982

(\$ billions)

	<u>1981</u>	<u>1982</u>
<u>Sources</u>		
Exports	23.9	23.0
oil	11.5	10.5
gas	3.4	3.5
other	9.0	9.0
Arms, Transfers, and Invisibles	5.2	4.8
Net Credits Drawn	1.1	1.4
commercial	0.8	1.1
gov't guaranteed	0.3	0.3
Decline in Assets in Western Banks	4.1 ^{1/}	1.6
Gold Sales	2.8	4.5
<u>Total</u>	37.5	35.3

Uses

Imports	29.9	30.9
agricultural	12.0	13.0
non-agricultural	17.9	17.9
Non-accountable to include: balancing of bilateral accounts in Comecon, capital outflows abroad, etc.*	7.6	4.4
<u>Total</u>	37.5	35.3

^{1/} As of September 1981.

* These non-accountable items in the Soviet's hard currency accounts are a residual item whose accounting function is to balance the sources and uses of hard currency. In balance of payments terminology, the residual is referred to as "errors and omissions".

CONFIDENTIAL